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In the Supreme Court of the United States

OCTOBER TERM, 1987

GUY F. ATKINSON COMPANY OF CALIFORNIA AND SUBSIDIARIES, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

CHARLES FRIED
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

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Petitioners contend that, under the completed contract method of accounting, they were entitled to deduct their losses arising from a long-term contract in a year in which they ceased work on an uncompleted contract, were declared in default, and commenced a damages suit against their customer.

1. Petitioner Guy F. Atkinson Co. is the corporate parent of a participant in a joint venture, Water Tunnel Contractors (WTC), that was formed to construct a water tunnel for the City of New York. Petitioners had a 30% share of WTC's gains and losses from the water tunnel project, which they were required to report on their consolidated federal income tax return. Pet. App. A13. For federal income tax purposes, WTC elected to report the income and expenses from the water tunnel project under the completed contract method of accounting (*id.* at A18-A19), which is authorized by Treas. Reg. § 1.451-3

(reprinted at Pet. App. A38-A55). That reporting method is an exception to the requirement that income and expenses be reported on an annual basis. It provides that the gross income and expenses from each long-term contract should be accumulated during the life of the contract and reported once on the tax return for the year in which the contract is completed.

WTC began work on the water tunnel in 1970 and immediately experienced significant delays and unanticipated expenses. In 1975, when the tunnel was less than 60% complete, WTC stopped work on the contract. The City of New York then declared WTC to be in default. WTC sued the City seeking rescission of the declaration of default, the return of property and equipment, and $205 million in damages. The City counterclaimed for $369 million in damages. The lawsuit was settled in 1979 in an agreement that required the City to pay $23.5 million to WTC and to rescind the declaration of default. In the interim, the City let a contract to another joint venture to complete the project. Pet. App. A2-A3.

On their 1975 tax return, petitioners sought to deduct a loss of more than $21 million as their share of the excess costs over receipts from the water tunnel project (Pet. App. A20). The Treasury Regulations that describe the completed contract method of accounting require reporting of income and expenses arising from a long-term contract in the taxable year in which the contract is "completed" (§ 1.451-3(d)(1) (Pet. App. A42)), and specify that a long-term contract is considered "completed" upon "final completion and acceptance" (§ 1.451-3(b)(2) (Pet. App. A40)). Maintaining that the water tunnel contract was not "completed" in 1975, the Commissioner determined that 1975 was not the correct year in which to report the loss and disallowed petitioners' claimed loss deduction. Pet. App. A3.

2. Petitioners sought review of that determination in the Tax Court, which sustained the Commissioner's position (Pet. App. A12-A37). The court held that the contract between WTC and the City was not "completed" in 1975 because the cessation of work coupled with the claims that each party made against the other did not amount to the "final completion and acceptance" required under the terms of the regulation (*id.* at A22-A23, A26-A32). The court also rejected petitioners' claim that the "dispute provisions" of the regulations (§ 1.451-3(d)(2), (3), and (4); (Pet. App. A42-A49)) should permit them to deduct part of their claimed loss in 1975, even in the absence of completion of the contract (Pet. App. A24-A26). The dispute provisions allow a taxpayer who "tenders the subject matter of a long-term contract" (Pet. App. A42, A46, A48), even though there remain outstanding disputes between the taxpayer and his customer regarding the price or additional work to be performed, to report the results in the year in which the contract is completed (without regard to the dispute). The Tax Court held that those provisions apply only in situations in which the taxpayer has "substantially completed" the project (*id.* at A24). The court explained that the examples in the dispute provisions "make it obvious that these regulations do not apply in cases where midstream termination of performance occurs" (*ibid.*).

The court of appeals affirmed (Pet. App. A1-A10). It agreed with the Tax Court that WTC's unilateral cessation of work on the water tunnel did not constitute "final completion and acceptance" of the contract, noting that more than 40% of the project remained incomplete and that the City did not "accept" the cessation of work, instead declaring WTC in default and suing for breach of contract (*id.* at A4-A7). The court characterized petitioners' reading of the regulations here as one that "would permit unilateral work stoppage and the taking of possession by the buyer

to circumvent the completed contract method" (*id.* at A6 (footnote omitted)). The court concluded that, in a situation like the one presented here, the regulations recognize completion of the contract "only upon final resolution of the parties' claims by agreement or by authoritative decree" (*id.* at A7). The court also held the dispute provisions inapplicable because both general contract principles and the examples set forth in the regulations demonstrate that the events that took place in 1975 did not constitute a "tender of the subject matter of the contract" (*id.* at A7-A9). The court explained that WTC "lacked the ability to perform" the contract when it ceased work and that the completed work did not "approximate what was due under the contract" (*id.* at A8-A9); hence, there was no tender of the subject matter of the contract.

3. The courts below were correct in rejecting petitioners' contention that they are allowed, under the completed contract method of accounting, to take a deduction in 1975 for their losses on the water tunnel contract. Moreover, this issue in any event would not be appropriate for review by this Court. Petitioners allege no conflict with any decision of this Court or of another court of appeals. This case simply involves the application of a detailed and complex regulation to the particular facts at hand, which are sufficiently unusual that petitioners have been unable to find any cases even remotely analogous that have been decided more recently than 1969 (see Pet. 18). In sum, petitioners have advanced no reason why this case warrants the attention of this Court.

Petitioners do not challenge the conclusion that WTC's contract was not completed in 1975. They do contend (Pet. 10-17), however, that the dispute provisions should be applied to this case to allow petitioners to take a loss in a year prior to the completion of the contract. This con-

tention misapprehends the purpose of the dispute provisions. Those subsections provide that a taxpayer may defer reporting disputed items of income or expense until the dispute is resolved, but they do not purport to alter the general rule that items not in dispute must be reported in the year in which the contract is completed. They can provide no basis for what petitioners seek to do here—accelerate the deduction of an anticipated loss on a long-term contract into a year prior to the one in which the contract is completed.

The Tax Court stated that the dispute provisions do not apply until the contract is "substantially completed" (Pet. App. A24); in the same vein, the court of appeals stated that there can be no "tender" under those provisions unless the work completed "approximate[s] what was due under the contract" (*id.* at A9). Petitioners maintain that this reading renders the provisions "essentially meaningless" (Pet. 11), but this assertion is clearly mistaken. The completed contract provisions generally require full performance; the dispute provisions clarify this rule in cases where there has been substantially complete performance, but there remain some areas of dispute about price and whether performance is actually complete. But these provisions are not intended to undermine the basic purpose of the regulation to require reporting in the year in which all or substantially all the results of the contract are known. They certainly do not allow a taxpayer to report the partial results of an incomplete long-term contract in the year in which a party unilaterally ceases work under a contract and sues its customer for damages.[1]

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[1] It is true that a contract may be "completed" for purposes of the regulation if work on the contract is stopped in accordance with the parties' mutual agreement that the contractual agreement is at an end. But that is clearly not the case here. Regardless of the merits of the contract dispute between the parties (see Pet. 16 n.9), it cannot be

As the courts below explained (Pet. App. A9, A24-A25), the examples in the regulations make clear that the dispute provisions apply only where there has been a tender of a substantially completed project. Of the nine examples in the dispute provisions, eight expressly involve a factual situation in which the taxpayer "finishes construction" of the project; the ninth example, while not using that phrase, clearly contemplates that the taxpayer has tendered to his customer a finished office building, albeit one in which the customer "is dissatisfied with certain aspects of the construction." Treas. Reg. § 1.451-3(d)(4)(ii), Example 2 (Pet. App. A49).

In any event, even if petitioners were correct in contending that the dispute provisions apply to their situation, the terms of those regulations would not permit them to deduct a loss on the contract in 1975. Section 1.451-3(d)(2)(ii) (Pet. App. A42-A43) establishes an exception to the general thrust of the dispute provisions. See also § 1.451-3(d)(4)(i) (Pet. App. A48). If the existing dispute renders it impossible to determine whether a profit or loss will ultimately be realized on the contract, neither income nor expenses of the contract may be reported in the year that the contract is completed (without regard to the dispute). In light of WTC's pending lawsuit against the City seeking $205 million in damages, it was impossible to ascertain in 1975 whether they would ultimately enjoy a gain or suffer a loss

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disputed that the cessation of work was not by agreement. As the Tax Court found (Pet. App. A27): "WTC's unilateral decision to terminate performance followed by the City's possession of the tunnel and associated assets does not constitute a mutually agreed upon modification of the contract. The City's counterclaim in 1977 for breach of contract underscores this conclusion." In this case, the contract between WTC and the City was not ended until the multi-million dollar lawsuit and countersuit were settled in 1979.

on the contract, and thus Section 1.451-3(d)(2)(ii) would preclude them from taking a deduction in that year.[2]

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

CHARLES FRIED
Solicitor General

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[2] Petitioners do not claim a conflict in the circuits, but they do assert (Pet. 18-19) that the decision below conflicts with the reasoning of some old Tax Court cases, even though those cases did not involve the dispute provisions. Petitioners acknowledge that two of the cases they cite, which were noted approvingly by the Tax Court here (see Pet. App. A27 n.2, A29), are inapposite because "the originally contracted work appears to have been substantially completed" (Pet. 18). It is not apparent why petitioners rely upon the third case, *National Contracting Co.* v. *Commissioner*, 37 B.T.A. 689 (1938), aff'd, 105 F. 2d 488 (8th Cir. 1939). As the Tax Court pointed out (Pet. App. A27 n.3), it was undisputed in that case that the contract was "completed" in the year in which the taxpayer sought to take the deduction (see 37 B.T.A. at 701), and thus the decision has no bearing on the issue presented here.

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